

IT 96-50

Tax Type: INCOME TAX

Issue: 1005 Penalty (Reasonable Cause Issue)
Nexus (Taxable Connection With Or Even Within State)

THE STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS)	
)	
v.)	No.
)	FEIN:
TAXPAYER)	
)	C. Ladewig
)	Admin. Law Judge
Taxpayer)	
)	

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. John M. Hughes of Lord, Bissell & Brook, for TAXPAYER; Mr. Sean P. Cullinan, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to the taxpayers' timely protest of the Notice of Deficiency issued by the Illinois Department of Revenue (hereinafter referred to as the "Department") on December 17, 1993. At issue is whether TAXPAYER (hereinafter referred to as "TAXPAYER") had sufficient nexus with Illinois so as to require it to include destination sales in the numerator of the sales factor of its unitary combined return for tax years ending 1989 and 1990 and 2) whether the penalty should be abated due to reasonable cause. Following a submission of all evidence and a

review of the record, it is recommended that this matter be resolved in favor of the taxpayer.

Findings of Fact:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Deficiency dated December 17, 1993 for the taxable years ending 11/30/89 and 11/30/90 showing a total liability due and owing in the amount of \$58,606.00. Dept. Ex. No. 2.

2. For TYE 11/30/89 TAXPAYER (hereinafter referred to as "TAXPAYER") rented an office in Illinois with a sales force that solicited sales of TAXPAYER's products within Illinois. For TYE 11/30/89 TAXPAYER included all these Illinois sales in the Illinois sales factor numerator. Dept. Ex. No. 10. In TYE 11/30/90 TAXPAYER created COMPANY Supply Co. (hereinafter referred to as "COMPANY"), a subsidiary, and signed an agreement with COMPANY which established COMPANY as TAXPAYER's sales representative in Illinois. For TYE 11/30/90 TAXPAYER excluded Illinois sales and was not an Illinois filer. TAXPAYER filed a unitary return for both 1989 and 1990. Tr. p. 39. In 1990, COMPANY was a member of the unitary group (Tr. p. 39) which included only the sales commissions of COMPANY in the numerator of its sales factor. Dept. Ex. No. 11; Tr. pp. 39, 40.

3. As a result of the audit, TAXPAYER's Illinois destination sales were included in the sales factor numerator. Tr. pp. 41, 42, 122. In addition, the auditor excluded the commissions from TAXPAYER that were in the numerator of COMPANY's sales factor. Tr. p. 42.

4. During TYE 1989, TAXPAYER owned 100% of the stock of CUSTOM ("CUSTOM") and TAXPAYER Data Products, Inc. ("TAXPAYER Data"), and various other companies. During TYE 1990 TAXPAYER owned 100% of the stock of CUSTOM, Data, COMPANY Supply Company ("COMPANY"), PRODUCTS ("PRODUCTS"), and TAXPAYER Management Company ("TAXPAYER Management"), and various other companies. Stip. ¶ 1. The list of officers and directors as contained in Department Exhibit No. 7 is almost identical (except for some minor differences) to the list of officers and directors in the tax years at issue. Stip. ¶ 2.

5. There were common directors and officers between TAXPAYER, TAXPAYER Management, CUSTOM, PRODUCTS Products, TAXPAYER Data, and COMPANY. Tr. pp. 157, 158.

6. CUSTOM and TAXPAYER Data were determined to not have nexus with Illinois. Tr. pp. 75, 137. These two companies were part of the TYE 1990 unitary group, (Tr. p. 137) and were not allocating any sales to Illinois. Tr. p. 137. TAXPAYER Management was also a member of the Illinois unitary business group for the fiscal year ending 1990. Tr. p. 139.

7. PRODUCTS, another affiliate, had an inventory in Illinois and allocated that inventory and their destination sales in Illinois into the numerator. Tr. pp. 40, 41; Dept. Ex. No. 6.

8. COMPANY employed nine people out of their office. Tr. p. 177. Since June of 1995, their office has been located at in Itasca. Tr. p. 176. Previously the office was located at North. Tr. p. 177.

9. In TYE 1990, COMPANY, Data, and PRODUCTS all entered into service agreements with TAXPAYER Management that were identical to the agreement attached to Department Group Exhibit No. 3,

specifically what is marked Exhibit H in TAXPAYER's 3/8/93 letter. Stip. ¶ 4. COMPANY, CUSTOM, PRODUCTS and TAXPAYER Data paid this management company a fee for its services. Tr. p. 148. COMPANY entered into a sales representative agreement with four other companies, namely, TAXPAYER Manufacturing, TAXPAYER Data, CUSTOM and PRODUCTS. Tr. pp. 73, 74.

10. The sales representative agreements states "All orders shall be subject to acceptance by TAXPAYER and orders which are accepted shall be shipped and invoiced by the company directly to the customer". Tr. pp. 82, 83. The agreement provides that the sole compensation to be received by representative, COMPANY, from the company for services shall consist of commissions at the rate of three percent of the net invoice price. Tr. p. 83. These commissions were being paid in the form of intercompany transfers. Tr. p. 84. The agreement also allows COMPANY the right to employ suitable and desirable salesmen and other personnel to aid in the performance of representative services under this agreement. Tr. p. 85. The agreements provide in Section 5 that the relationship is to be that of an independent contractor. Tr. p. 85. Under the terms of the agreement, TAXPAYER controlled COMPANY's territory, that is it could increase, decrease or otherwise change it with 10 days written notice. Dept. Ex. No. 3. TAXPAYER maintained the right to set the prices of products covered by the sales representative agreement and could accept or reject any order in its sole discretion. TAXPAYER could reduce the product lines that COMPANY handled. Dept. Grp. Ex. No. 3.

11. The auditor examined the unemployment tax returns filed by COMPANY (Tr. p. 125) and found they indicated a certain number of people were being treated as employees of COMPANY for federal and state unemployment insurance purposes. Tr. p. 126.

12. TAXPAYER was listed in the 1992 telephone book listing at with an Illinois phone number. Dept. Grp Ex. No. 3. Such listing was outside the audit period.

13. At the Department's Paramus office and in the presence of TAX MANAGER, COMPANY's tax manager, the auditor called COMPANY's Illinois office and the receptionist answered, "TAXPAYER, may I help you?" Tr. pp. 42, 43.

14. In addition to displaying the COMPANY name, the business cards that COMPANY salesmen used indicated the "TAXPAYER" name and logo on them. No other manufacturers' names are listed. Tr. p. 44.

15. In 1990, TAXPAYER had no Illinois workers or employees on its payroll. Tr. p. 75. On November 21, 1989, the lease that TAXPAYER previously held as office space in Illinois was assigned to COMPANY. Tr. pp. 76, 77, Dept. Ex. No. 3. TAXPAYER informed the landlord that a transfer was made. Tr. p. 76.

16. Line 16D provides that "Landlord's consent to any assignment or subletting shall not release the tenant of liability, ... unless specifically provided in such written consent. Tr. p. 89. The lease also provides "Landlord's prior written consent shall not be necessary if tenant assigns or transfers this lease or sublets the desired premises in whole or in part to any entity to which tenant may be merged or consolidated or to which may be a parent subsidiary or affiliated tenant." Tr. p. 90; Dept. Grp Ex. No. 3.

17. The financial obligations of COMPANY were being paid out of a COMPANY's bank account at a Georgia bank. Tr. p. 77.

18. TAXPAYER's headquarters are in Pennsylvania which does not have a throwback rule. Tr. p. 106.

19. The independent representative agreement between TAXPAYER and COMPANY contained the following provisions:

1. TAXPAYER may add or delete products.
2. TAXPAYER may make changes in COMPANY's territory from time to time at its sole discretion.
3. COMPANY is not allowed to solicit the sale of or otherwise deal with any products which may compete with TAXPAYER's products.
4. If the customer returns a product the representative must refund the commission to TAXPAYER.
5. The representative or company may terminate the agreement at any time with or without cause with thirty days prior written notice.
6. "The Company, (TAXPAYER), reserves the sole right to declare any account an exclusive account whereby commissions for sales to this account are to be paid to the territory where the order was generated. The Company reserves the sole right to declare any account a "House Account" and all sales to this account will be non-commissionable. In addition, the Company reserves the right to change the commission rate at any time upon written notice to representative."

Dept. Grp. Ex. No. 3.

20. The invoices for customer orders are sent from TAXPAYER on their own invoice forms to the customers, the products are delivered to the customer by TAXPAYER and the other companies. The customers make payment directly to TAXPAYER or the other companies. Dept. Grp. Ex. No. 3.

Conclusions of Law:

Congress enacted Public Law 86-272 to restrict the power of the States to tax interstate businesses. P.L. 86-272 provides in part:

For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office of such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

15 U.S.C. §381

Section (d) further provides: (1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and (2) the term "representative" does not include an independent contractor." *Id.*

An out-of state company is afforded tax immunity by P.L. 86-272 if the company makes sales through independent contractors within the taxing state. "Theoretically, the rationale behind this protection must be that an independent contractor who receives a fee for his services is subject to state taxation on that income. The independent contractor's tax payment for benefits received from the state relieves the out-of-state company from taxation." Sweeney, *State Taxation of Interstate Commerce Under Public Law 86-272*: "A

Riddle Wrapped in an Enigma Inside a Mystery" 169 B.Y.U. L. Rev. 169 (1984).

Taxpayer claims that it does not have nexus in Illinois, rather that one of its wholly owned subsidiaries, COMPANY, is the only corporation with nexus in Illinois. TAXPAYER maintains that COMPANY is an independent contractor and thus, TAXPAYER is afforded tax immunity under P.L. 86-272. As an independent contractor COMPANY would be allowed to maintain an office in Illinois and still avoid taxation. To determine if TAXPAYER's activities in Illinois are protected under P.L. 86-272 and thus, immune from Illinois taxation one must look to the language of the statute.

To establish itself as an independent contractor one must meet the definition of independent contractor as defined in P.L. 86-272. The statute provides that an independent contractor is a "commission agent, or broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities." 15 U.S.C. §381(d)(1). Some courts have determined this definition circular due to the fact the definition contains the very word being defined. As a result, courts have looked to local law for assistance. See, Herff Jones Co. v. State Tax Commission, 247 Or. 404; Tonka Corp. Commissioner of Taxation, 284 Minn. 185. Following such guidance it follows that to establish oneself as an independent contractor the taxpayer must qualify as an independent contractor as a matter of common law, in addition to the requirements outlined in the statute, that is; it must represent more than one principal, and hold itself

out as an independent contractor in the regular course of its business activities.

The first issue for consideration is whether COMPANY can be considered an independent contractor as a matter of common law.

The Restatement provides guidance in analyzing the agency relationship. It provides that: "Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." RESTATEMENT OF THE LAW 2d, Agency § 1. What differentiates an independent contractor from an employee agent is the degree of control exercised by the principal over the method and details of the agent's performance. *Id.*

Of primary consideration in the determination of whether a person is acting as an independent contractor or as an employee is the degree and character of control exercised over the work being done. "The relationship of principal and agent exists if the principal has the right or the duty to supervise and control, and also the right to terminate the relationship at any time." Dumas v. Lloyd, 6 Ill. App. 3d 1026 (1st Dist. 1972) quoting Hulke v. International Manufacturing Co., 14 Ill. App. 2d 5. "The test is in the right to control and is not dependent upon its exercise." Dumas v. Lloyd, *supra* quoting Darner v. Colby, 375 Ill. 558. Looking at the case law the Department cites one can see that the courts are looking to the amount of control the principal exercises or has the right to exercise over the agent's day to day operations. The service agreement between TAXPAYER Management and COMPANY establishes that it is TAXPAYER Management with the right and obligation to

handle all of the day to day operations of COMPANY. The mere fact that TAXPAYER and TAXPAYER Management are affiliated companies is insufficient grounds to conclude that TAXPAYER has any supervision or control over COMPANY's day to day operations. Evidence of such control is not reflected in the record.

The Department cites Manahan v. Daily News-Tribune, 50 Ill. App. 3d 9 to support its contention that TAXPAYER exercised the necessary control over COMPANY. The principal in Manahan had the following rights: to determine the independent contractor's territory, to set the prices of the newspapers, and to change the independent contractor's territory if desired. Given these facts, which are similar to those in the case at hand, the court in Manahan still determined the newspaper deliveryman to be an independent contractor. Based upon this record, TAXPAYER does not wield the requisite day to day operational control that would preclude COMPANY from being classified an independent contractor. Further, the agreement entered into between TAXPAYER and COMPANY is almost identical to other sales representative agreements between TAXPAYER and JBS Sales and Marketing and Pacific Four Sales, Inc. See, Stip ¶13; Joint Exhibits A & B. Accordingly, these contracts between TAXPAYER and COMPANY reflect some degree of arm's length negotiation.

The second issue for consideration is whether COMPANY represented more than one principal in its representation of TAXPAYER, CUSTOM, TAXPAYER Data, and PRODUCTS.

TAXPAYER and the other companies that COMPANY represents constitute separate legal entities, and thus should be respected as such. In practice, the corporations maintained separate identities

in that they each had systems in place for credit checks, delivery and invoicing. Each company had a legally binding agreement with COMPANY and the auditor testified that TAXPAYER and the other companies were paying commissions to COMPANY as required. These commission rates were comparable to rates paid to other representatives. See, Stip. ¶3; Joint Exhibits A & B. In Illinois, common ownership of corporations does not cause the companies to lose their separate identities and justify them being treated as one company or as the agent of one another. See, Main Bank of Chicago v. Baker, 8 Ill. 2d 188, (1981). The Department itself acknowledged that TAXPAYER's 100% stock ownership of the other companies does not mean that the separate companies should not be respected. Furthermore, there is nothing in the record to suggest that TAXPAYER Management should not be respected as a separate entity.

The third issue for consideration is whether COMPANY sufficiently held itself out as an independent contractor in the course of its business dealings to satisfy the statute.

The auditor admitted that it is not unusual for an independent contractor to have its largest vendor on its business cards. Such was the case here. In addition to the "TAXPAYER" name and logo, the business cards also bore the name "COMPANY Supply Company" which I believe was sufficient to put customers on notice that they were dealing with someone other than the principal, TAXPAYER. Further, the record reflects that not only did TAXPAYER invoice and ship products directly to the ultimate customer but that the other principals, namely, CUSTOM, TAXPAYER Data and PRODUCTS also directly invoiced and shipped to the customer. Each principal handled its own

customer complaints directly with the customer. Such activity directly put customers on notice that COMPANY was acting as an independent contractor and further that it was acting on behalf of more than one principal. In addition, the customers made payment directly to each company. As far as the customers were concerned, COMPANY was acting only as a sales representative and not as a principal. The fact that TAXPAYER was COMPANY's largest customer does not automatically mean that COMPANY's status as independent contractor should be disregarded. As mentioned, the record reflects the parties had a legally binding agreement and no evidence suggests that the parties did not adhere to the contract provisions.

Based upon this record, COMPANY has qualified as an independent contractor and thus is protected under the provisions of P.L. 86-272. Accordingly, I recommend that the Notice of Deficiency be cancelled.

Christine E. Ladewig
Administrative Law Judge